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No. 88-36

In the Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, ET AL., PETITIONERS

v.

ROBERT M. DEUTSCHMAN

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether a purchaser of an option on a security has standing to sue the non-trading issuer of the underlying security under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, for material misrepresentations made by the issuer.

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. This class action was brought pursuant to the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, by respondent Robert M. Deutschman against the petitioners, Beneficial Corporation and two of its officers. Respondent alleges that he and the class he seeks to represent were injured, as a result of false or misleading statements by petitioners, in connection with the purchase of publicly traded options to purchase shares of Beneficial stock.[1] Petitioners are

[1] Respondent seeks to assert claims on behalf of a class consisting of all investors who purchased either call options on Beneficial common stock *or* Beneficial common stock during a class period from August 21, 1986 through February 27, 1987 (Br. in Opp. App. ¶ 15). Respondent has not alleged, however, that he purchased any Beneficial common stock during this period (*id.* ¶ 6). The question whether respondent, as a purchaser of call options, may properly serve as a representative of a class consisting of persons who purchased Beneficial common stock was not passed upon by the lower courts and is not presented by the petition. See Pet. 4-5 n.1.

not alleged to have had a role in the issuance of the options.[2] Nor are petitioners alleged to have traded either in the options or in Beneficial stock during the class period.

Respondent alleges that in 1986 petitioners knowingly or recklessly made false or misleading statements (and failed to correct in a timely fashion statements known to be false or misleading) that significantly understated projected losses for the reinsurance segment of Beneficial's business.[3] Respondent alleges that he purchased his call options on the Pacific Stock Exchange at prices artificially inflated by the market's reliance on petitioners' fraudulent statements. When Beneficial's actual reinsurance losses became known, the price of Beneficial stock declined, remaining below the price at which the options could be exercised profitably. The options, whose price also had declined, expired in January 1987 without being exercised or sold. Respondent allegedly incurred out-of-pocket losses of approximately $14,000 in connection with his option purchases (Br. in Opp. App. ¶ 6).

2. The district court dismissed the complaint (Pet. App. 26a). Relying on *Chiarella* v. *United States*, 445 U.S. 222 (1980); *Dirks* v. *SEC*, 463 U.S. 646 (1983); and *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (8th Cir. 1982), cert. denied, 464 U.S. 846 (1983), the court held that an issuer may be sued for misrepresentations only if a transactional nexus or fiduciary relationship exists between the issuer and the plaintiff (Pet. App. 21a). The court noted that Beneficial neither issued nor traded option contracts, and therefore concluded that there was no transactional or fiduciary relationship between Beneficial

[2] Options listed on a securities exchange, such as the Beneficial options in question here, are issued by the Options Clearing Corporation and have standardized features to facilitate public trading. Beneficial did not cause its options to be listed and had no control over whether the options were listed.

[3] The alleged misrepresentations were made in letters from Beneficial's chairman and chief executive officer to its shareholders, corporate press releases, periodic reports filed with the Securities and Exchange Commission, and quotations attributed to Beneficial's officers appearing in the financial press (Compl. ¶¶ 21, 25(a), 28(b) and (c), 40(b) and (c), 42(a), 48, 50, *reprinted in* Br. in Opp. App 10a, 12a, 15a-16a, 24a-25a, 28a-29a).

and the purchasers of options. The court accordingly found that respondent lacked standing to sue Beneficial for false statements.[4] The court stated in support of its holding that option traders provide no more than a *de minimis* contribution to a corporation's capital formation (*id.* at 21a, 25a), and typically accept greater risk than purchasers of the underlying stock (*id.* at 25a). Moreover, since the corporation does not issue the options, it lacks any control over the number of options written with respect to its securities, and thus over its potential liability to option traders (*id.* at 24a). These factors, the court reasoned, counsel against permitting option traders to "recover at the expense of the corporation's shareholders" (*id.* at 25a).

3. The court of appeals reversed. The court found (Pet. App. 6a-9a) that respondent's complaint alleged each of the recognized elements of a cause of action under Rule 10b-5, including that petitioners made material misrepresentations with the requisite scienter, and that respondent, as a purchaser of securities, satisfied the standing requirement of *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). The court refused to adopt any additional threshold standing requirements, not required by the language of the statute or the regulation, to deny a cause of action to option traders who allege injury from affirmative issuer misrepresentations.

The court rejected the district court's reliance on *Chiarella* and *Dirks* to impose a requirement of a fiduciary relationship between Beneficial and the option traders. The court explained (Pet. App. 9a-10a) that those insider trading decisions hold that a person is not liable under Rule 10b-5 for failing to disclose material information unless the person has a duty to disclose such information to the plaintiff, a duty that arises out of a fiduciary relationship. In contrast, the court stated (Pet. App.

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[4] The district court also read *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S 723 (1975), to require the plaintiff in a Rule 10b-5 action to be a purchaser or seller of securities "issued by the defendant corporation" (Pet. App. 22a (emphasis omitted)). Because the options were not issued by Beneficial, the court concluded that respondent failed to meet the standing requirement of *Blue Chip*. The court of appeals rejected that argument (Pet. App. 8a-9a), and petitioners do not seek this Court's review of that holding.

9a), liability for affirmative misrepresentations does not rest on breach of a duty of disclosure. While the complaint did not allege that Beneficial and its officers had a duty to disclose information to respondent, petitioners chose to speak, and "in speaking they were not free to lie" (*id.* at 10a).

The court likewise concluded that the district court's reliance on the Eighth Circuit's decision in *Laventhall* to impose a transactional nexus requirement was misplaced. That decision, the court explained, involved only a claim by an option trader against a corporation based on the corporation's failure to disclose information when trading in its own securities. The defendants there did not make affirmative misrepresentations to the public. In contrast, the court found, neither this Court nor any court of appeals has required a transactional nexus between a plaintiff and a defendant in a Rule 10b-5 case involving affirmative misrepresentations (Pet. App. 10a-11a).

Finally, the court rejected petitioners' policy arguments for limiting option traders' standing. The court questioned the district court's assumptions that option traders assume greater risk than equity holders, and that they contribute less than equity traders do to capital formation. The court observed that options frequently are used to hedge risk (Pet. App. 12a), and may contribute to market liquidity for the issuer's securities (*id.* at 13a). In any event, the court stated, the utility of options was a matter more properly left for legislative determination, and courts should not second-guess Congress's judgment to treat options as securities subject to the protection of the federal securities laws (*id.* at 12a-13a).

DISCUSSION

The decision below is the first by a court of appeals to address the standing of option traders to sue the issuer of the underlying security under Rule 10b-5 for affirmative misrepresentations. The court of appeals' rejection of a rule that would deny standing to option traders under these circumstances is consistent with the language and purposes of Rule 10b-5 and with the decisions of this Court, and does not conflict with the decision of

any other court of appeals. Nor do the policy considerations advanced by petitioners require imposition of a new standing limitation on Rule 10b-5 private actions by options traders. Accordingly, this Court's review of the question presented is not warranted at this time.

1. A fundamental purpose of the Securities Exchange Act of 1934 (Exchange Act) is to promote full and accurate disclosure of information by corporations in order "to protect investors against manipulation of stock prices." *Basic Inc.* v. *Levinson,* 108 S. Ct. 978, 982 (1988). This Court has long recognized that one of the "essential tool[s]" in achieving this purpose is the private right of action implied under Section 10(b) and Rule 10b-5. *Basic*, 108 S. Ct. at 982-983; *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 380 n.10 (1983); *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 196 (1976); *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 730 (1975); *Superintendent of Insurance* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

a. An action under Section 10(b) and Rule 10b-5 "can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative or deceptive device or contrivance.' " *Herman & MacLean* v. *Huddleston,* 459 U.S. at 382. The court of appeals correctly concluded (Pet. App. 7a-9a) that option traders fall within the broad language of the Rule describing the class of persons protected.[5]

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[5] Contrary to petitioners (Pet. 12-14), we do not believe that the decision below conflicts with *Cort* v. *Ash,* 422 U.S. 66 (1975), or any other decision of this Court regarding the general standards for implying a cause of action from a federal statute or regulation. An implied right of action under Rule 10b-5 has long been enforced by the courts, and sanctioned by congressional acquiescence. *Basic,* 108 S. Ct. at 982-983. The existence of such an action "is simply beyond peradventure." *Herman & MacLean* v. *Huddleston,* 459 U.S. at 380 & n.10. Thus, we do not agree with petitioner's contention (Pet. 14) that, to find standing, there must be an "unmistakable focus" on option traders in Section 10(b) and Rule 10b-5. Those provisions, which do not mention any type of security by name, focus on options to the same degree as they do on any other type of security. Petitioners also err is suggesting (Pet. 13) that, to find standing, there must be a "pervasive legislative scheme governing the relationships at issue between the plaintiff group and the defendant." Peti-

There can be no question that the phrase "any security" as used in Section 10(b) and Rule 10b-5 includes publicly traded options, such as the call options on Beneficial common stock acquired by respondent. Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), defines "security" to include "any put, call, straddle, option, or privilege on any security." Since its creation, the Securities and Exchange Commission (SEC) has exercised regulatory authority over trading in options on securities. H.R. Rep. No. 626, 97th Cong., 2d Sess. 3-4, 6 (1982). The definition of a "security" was amended in 1982 (Act of Oct. 13, 1982, Pub. L. No. 97-303, § 1, 96 Stat. 1409) specifically to include options on securities in order to clarify and confirm that historic regulatory authority and to resolve uncertainty over the jurisdictional boundaries between the authority of the SEC and the Commodity Futures Trading Commission. H.R. Rep. No. 626, *supra,* at 3-4, 6-8.[6]

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tioners cite no case that, in finding standing under Section 10(b) and Rule 10b-5, has rested its analysis on the existence of such a legislative scheme

[6] Congress again confirmed this understanding when it amended the Exchange Act to make explicit that insider trading in the options markets is unlawful to the same extent as it is in the markets for the underlying securities. The Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, § 5, 98 Stat. 1265, added Section 20(d) to the Exchange Act, 15 U.S.C. 78t(d) (Supp. V 1987). That section provides that whenever trading in a security while in possession of material, nonpublic information would violate the securities laws or rules thereunder or result in liability to a purchaser or seller of the security, "such conduct in connection with a purchase or sale of a[n] * * * option * * * with respect to such security * * * shall also violate and result in comparable liability to any purchaser or seller of that security." Although ITSA concerns only liability for insider trading, and thus is not directly applicable to a case involving affirmative misrepresentations, it reflects Congress's intention that traders in option contracts should be treated no differently from traders in other securities for purposes of determining liability under Section 10(b) and Rule 10b-5. See 130 Cong. Rec. 20,107-20,108 (June 29, 1984) (statement of Sen. D'Amato); 130 Cong. Rec. 20,968-20,969 (July 25, 1984) (statement of Rep. Dingell). Commentators have noted that Section 20(d), 15 U.S.C. 78t(d), provides standing for options traders to sue for insider trading under Rule 10b-5. See L. Loss, *Fundamentals of Securities Regulation* 732-733 n.29 (1988); Wang, *A Cause of Action of Option Traders Against Insider Option Traders,* 101 Harv. L. Rev. 1056 (1988).

Furthermore, respondent has satisfied the statutory requirement of pleading fraud "in connection with the purchase or sale of any security." In order to have standing to sue under Rule 10b-5, a plaintiff must allege that he either purchased or sold a security, *Blue Chip Stamps, supra,* and that the deceptive practice "touched" that purchase or sale, *Superintendent of Insurance* v. *Bankers Life & Cas. Co.,* 404 U.S. at 12-13. These requirements are readily satisfied in this case: the complaint alleges (Br. in Opp. App. 30a) that respondent purchased call options on Beneficial stock "at artificially inflated prices and in a false market climate created by [petitioners]." See *Blue Chip Stamps,* 421 U.S. at 751 ("the holders of puts, calls, options and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5 * * * because the definitional provisions of the 1934 Act themselves grant them such a status.").

Finally, the "in connection with the purchase or sale" language does not require that the *defendant* must be engaged in the purchase or sale of the security in question. Any such requirement would mean that a corporation could not be sued by its own shareholders (or for that matter by the SEC in an enforcement action) for affirmative misrepresentations unless it was simultaneously trading in its own shares. Yet private as well as government actions against the issuer of a security for material misrepresentations have long been recognized to satisfy the "in connection with the purchase or sale" requirement of Rule 10b-5. See *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 858-862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); *Heit* v. *Weitzen,* 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969); L. Loss, *Fundamentals of Securities Regulation* 736, 799-800 (1988).[7]

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[7] Petitioners' proposed standing limitation – requiring that there be "some relationship or transactional nexus" (Pet. 7, 15) between the plaintiff and the defendant – would perhaps have some textual foundation if the statute and the

In short, the court of appeals was clearly correct insofar as it discerned no basis in the language of the statute or the Rule to adopt a special limitation on the standing of options traders to bring a private action against the issuer of the underlying security for affirmative misrepresentations.

b. Relying on this Court's recent insider trading decisions in *Dirks* v. *SEC,* 463 U.S. 646 (1983), and *Chiarella* v. *United States,* 445 U.S. 222 (1980), petitioners argue (Pet. 15) that an options trader cannot bring a Rule 10b-5 action against a corporation unless the corporation has some kind of fiduciary relationship or duty to the options trader. As the court of appeals properly held (Pet. App. 9a), however, the fiduciary duty requirement of those cases has no application in the context of claims based on affirmative misrepresentations.

Dirks and *Chiarella* require a breach of a fiduciary relationship (or a similar relation of trust and confidence) before liability may be imposed for *silence* by persons trading while in possession of material, nonpublic information. The finding of a fiduciary duty is necessary in this context to infer a duty to disclose; otherwise, mere silence is not unlawful. See *Dirks,* 463 U.S. at 657-658; *Chiarella,* 445 U.S. at 235.

As this Court expressly recognized in *Chiarella,* however, a person who owes no duty to disclose may still commit fraud if he chooses to speak and speaks falsely (445 U.S. at 227-228).[8]

Rule were written so as to prohibit the use of any misrepresentation or manipulative or deceptive device "in connection *with a security.*" Such a hypothetical statute would arguably suggest the need for a "connection" between the defendant and the particular security purchased or sold by the plaintiff. But of course the statute and the Rule do not say this. They prohibit the use of any misrepresentation or manipulative device "in connection with *the purchase or sale* of any security." The language of the Rule thus suggests that the required nexus or connection is not between the defendant's conduct and a particular security, but between the defendant's conduct and the plaintiff's purchase or sale. In other words, the language of the statute and rule supports the *Blue Chip Stamps* purchaser-seller standing limitation, but not petitioners' proposed standing limitation.

[8] "At common law, misrepresentations made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits

And the Court made it abundantly clear in *Basic* that Rule 10b-5 applies to "*affirmative misrepresentations* by those under no duty to disclose, (but under the ever-present duty not to mislead)" (108 S. Ct. at 988 n.18 (emphasis added)). The Court reaffirmed that "Rule 10b-5 is violated whenever assertions are made * * * in a manner reasonably calculated to influence the investing public, . . . if such assertions are false or misleading or are so incomplete as to mislead." *Basic,* 108 S. Ct. at 985 n.13 (quoting *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).[9]

The policy of the securities laws to encourage "honest publicity" (*Basic,* 108 S. Ct. at 982) and to protect investors against "any manipulative or deceptive device or contrivance" in violation of the rules of the Securities and Exchange Commission (§ 10(b), 15 U.S.C. 78j(b)) would be severely impaired by an arbitrary requirement of a fiduciary duty in cases involving allegations of affirmative misstatements. Courts have not demanded such a duty to trigger liability for misrepresentations under Rule 10b-5. See, *e.g., Manufacturers Hanover Trust Co.* v. *Drysdale Securities Corp.,* 801 F.2d 13, 20-22 (2d Cir. 1986), cert. denied,

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fraud only when he is under a duty to do so." *Chiarella,* 445 U.S. at 227-228. See also *Basic,* 108 S. Ct. at 987 n.17.

[9] The distinction between silence, on the one hand, and false or misleading statements, on the other, draws directly upon the language of Rule 10b-5 itself. Rule 10b-5(b) makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading * * * in connection with the purchase or sale of any security." In *Chiarella,* the Court took care to point out (445 U.S. at 225 n.5) that its decision did not involve Rule 10b-5(b), but involved only Rule 10b-5(a) and (c). Those provisions bar, respectively, the employment of "any device, scheme, or artifice to defraud" and engaging in "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person" (445 U.S. at 226). While a duty to disclose (created by a fiduciary relationship) is needed to make silence fraudulent under those provisions of the rule, it wrenches the Court's reasoning wholly out of context to insist that affirmative misrepresentations that expressly violate Rule 10b-5(b) give rise to no liability to options traders in the absence of a fiduciary relationship.

479 U.S. 1066 (1987); *Braun* v. *Northern Ohio Bank*, 430 F. Supp. 367, 371-380 (N.D. Ohio 1977).[10] Nothing in *Chiarella* or *Dirks* requires a different result.

For essentially the same reason, we do not believe that the decision below conflicts with the Eighth Circuit's decision in *Laventhall* v. *General Dynamics Corp.*, 704 F.2d 407 (1982) cert. denied, 464 U.S. 846 (1983). *Laventhall* did not concern liability for affirmative misrepresentations, and the Eighth Circuit's decision did not address that issue. In reaching a result that the Eighth Circuit itself characterized as "not free from doubt" (*id.* at 410), the *Laventhall* court held only that option traders could not sue the issuer of the underlying stock for *nondisclosure,* when the issuer had not engaged in options trading (*id.* at 412-413).

Because *Laventhall* was a nondisclosure case, the key issue was whether the relationship between option traders and corporate issuers gives rise to a duty of disclosure. 704 F.2d at 411-412. The court concluded that there was no duty of disclosure in these circumstances since, in its view, the issuer of an underlying security does not owe any fiduciary duty to traders in options that it did not issue. Moreover, the court held, even if the issuer stood in a fiduciary relationship to option traders, a duty to disclose information to option traders would have been triggered only if the issuer had also been a trader in options. The issuer, however, had traded only in the underlying stock, and not in options. Thus, the Eighth Circuit simply refused to impose *insider trading* liability when the plaintiff and defendant were trading in different markets.[11]

[10] See also 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 66.01[a], at 3-414 to 3-415 (rev. 2d ed. 1988) ("Nor is there now any question [under Rule 10b-5] that C can be held responsible for causing D to trade with E, even though C is unrelated to E, derives no benefit from the transaction, and is not a fiduciary of D." (footnotes omitted)); Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading,* 39 Ala. L. Rev. 381, 394-396 (1988) (criticizing cases, including the district court decision in this case, that rely on *Chiarella* to require a fiduciary duty before imposing liability for affirmative misrepresentations).

[11] The *Laventhall* court explained (704 F.2d at 414) that analogous limits on insider trading liability exist for persons trading in the same market, when the

c. The Third Circuit was also correct, in this case in finding that policy reasons do not support the denial of standing to option traders (Pet. App. 11a-13a). In general, allowing a private right of action by securities traders injured by fraud strengthens the overall enforcement of the federal securities laws, increases incentives for honesty in the nation's capital markets, and promotes the efficient operation of those markets. Such actions serve as a necessary supplement to the Commission's own enforcement of the securities laws. *Basic,* 108 S. Ct. at 983; *Bateman Eichler, Hill Richards, Inc.* v. *Berner,* 472 U.S. 299, 311 (1985); *J.I. Case Co.* v. *Borak,* 377 U.S. 426, 432 (1964). These considerations, which support the recognition of standing for options traders, are not outweighed by the policy concerns urged by petitioners.

(1) Petitioners suggest that it is unnecessary to grant standing to options traders in order to deter issuer fraud, because option traders simply duplicate the deterrent role played by investors in the issuer's securities (Pet. 23-24). There is some force to this contention. Options are traded only where there is a large and active market in the underlying security. Thus, for that reason, any injury suffered by options traders because of affirmative issuer misrepresentations will presumably also be visited on persons who have traded in the underlying security as well. Consequently, recognizing standing on the part of options traders often will not determine whether or not a suit is brought, but only the level of damages if it is successful.

That does not mean, however, that there will not be some cases in which only option traders will have an adequate incentive to sue.[12] Option traders may suffer losses that are propor-

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plaintiff's trading is not contemporaneous with that of the defendant. See *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) (limiting insider trading liability to "those investors trading contemporaneously with the insider"); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 5, 102 Stat. 4680 (codifying right of action for contemporaneous traders); H.R. Rep. No. 910, 100th Cong., 2d. Sess. 26-27 (1988) (approving case law development of the term "contemporaneous," citing, inter alia, *Wilson, supra*).

[12] Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis,* 100 Harv. L. Rev. 1959, 1963 & n.25 (1987).

tionately greater than those of investors in stock, in part because of the possibility of a partial or total loss of the premium paid on an option that expires without being sold or exercised. Thus, option traders may have a greater incentive to sue in cases where misleading statements produce only a relatively small movement in the price of the underlying security. And of course, even if investors in stock do sue, requiring issuers who commit fraud to pay additional damages for injuries sustained by options traders will increase the deterrent effect of the law.[13]

In addition to deterring future violations, civil remedies are meant to compensate victims. *Randall* v. *Loftsgaarden,* 478 U.S. 647, 664 (1986); S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) ("[I]f an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party."). An arbitrary limitation on the standing of option traders would leave unremedied the economic harm to option investors flowing directly from issuers' fraud.

(2) Petitioners also assert (Pet. 22, 24-26) that affording standing to option traders will result in enormous potential liability for issuers over which they have no control. However, petitioners' intimations of vast numbers of options traders waiting in the wings to file suit is unsubstantiated. The allegations in the complaint in this case indicate, for example, that the number of options is likely to be a fraction of both the number of shares outstanding and the number of shares traded.[14] There

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[13] This is not a situation, such as the Court confronted in *Illinois Brick Co.* v. *Illinois,* 431 U.S. 720 (1977), where affording standing to persons who suffer derivative injuries would either diminish the incentives of those who suffer primary injuries or would result in multiple recoveries for the same injury. The injury that an investor in stock incurs because of fraudulent misstatements by a corporation is in no sense "passed on" to options traders. Rather, investors in stock and options traders deal in different securities traded in different markets, and they suffer distinct injuries as a result of the issuer's misconduct.

[14] The complaint alleges that Beneficial Corporation had more than 22 million shares outstanding in the latter part of 1986, while, during the class period, about 50,000 call options (representing rights to acquire 5,000,000

are in fact several legal and practical restraints on option trading that impose limits on the number of options that may be written.[15]

Petitioners also ignore certain elements of a private Rule 10b-5 action that tend to reduce the scope of potential liability, each of which would apply to actions brought by options traders no less than other plaintiffs. Rule 10b-5 plaintiffs must prove scienter, which precludes issuer liability for negligent oversight or mistaken judgment. See *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). They must also show that any misstatements that have been made are material to investors. See *Basic,* 108 S. Ct. at 983. And private plaintiffs suing for damages must prove that they relied on such misstatements. See *id.* at 989.

Furthermore, even if petitioners' prediction of a vast expansion of liability were correct, it is not clear that this concern should be addressed by means of a restrictive standing rule.[16]

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shares) were sold. During that same period, the sales volume for Beneficial common stock was about 36 million shares (Br. in Opp. App. ¶¶ 7(d) and (e), 16).

[15] Option investors must meet certain suitability criteria that restrict the eligible pool of option investors. See, *e.g.*, Rules of the Board of Governors of the American Stock Exchange, Rule 923; Chicago Board Options Exchange, Inc., Rule 9.9. Investors are also subject to limits on the size of their positions and the amount of their position that they can exercise within given periods. See, *e.g.*, Rules of the Board of Governors of the American Stock Exchange, Rules 904, 905; Chicago Board Options Exchange, Inc., Rules 4.11, 4.12. Writers of uncovered call options—in which where the writer neither owns the underlying interest deliverable upon exercise of the call option nor possesses an offsetting option position—are required to meet margin requirements. 12 C.F.R. 220.5, 220.18; see The Options Clearing Corporation Rules 601 *et. seq*; Chicago Board Options Exchange, Inc., Rule 12.3. Finally, some private investors write call options on a covered basis. The willingness of such investors to engage in options trading is, in part, limited by the available outstanding shares of an issuer's stock.

[16] The concern with expanded liability voiced by petitioners is different in kind from the concerns cited by this Court in *Blue Chip Stamps* in support of the purchaser-seller standing requirement. See 421 U.S. at 730. The *Blue Chip Stamps* Court, in denying standing to persons who claimed they did *not* trade because they relied on fraud, was concerned with an expansion of issuers' liability resulting from the potentially fraudulent and unverifiable nature of

An alternative approach would be to impose a limitation on damages, for example, by applying to options traders an out-of-pocket-loss measure of damages, rather than a benefit-of-the-bargain measure.[17] Addressing petitioners' concerns about extensive liability through appropriate limitations on damages, rather than as a matter of standing, would also enable courts to evaluate the concerns raised by petitioners about the scope of potential liability on the basis of actual numbers, rather than mere speculation.[18]

Finally, even if some limitation on standing were thought to be desirable, it is far from evident that petitioners' proposed fiduciary relationship standard—requiring that the plaintiff show "some relationship or transactional nexus" to the defendant (Pet. 7, 15)—is the proper limiting principle. Petitioners' proposed standing limitation is more restrictive than the standing requirements that obtain under the common law of fraud. In cases of affirmative misrepresentation, the common law permits an action for fraud to be brought by any person who could be expected to rely on the misrepresentation, even if that person is a stranger to whom no fiduciary duty is owed and with whom no business has been transacted. See *Ultramares Corp.* v. *Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931). See also *Rusch Factor, Inc.* v. *Levin*, 284 F. Supp. 85, 90 (D.R.I. 1968) (applying Rhode Island law); *Haberman* v. *Washington Public Power Supply System*, 109 Wash. 2d 107, 165-170, 744 P.2d 1032, 1069-1071 (1987) (en banc), as amended, 750 P.2d

claims by non-traders. *Id.* at 142-144. In contrast, any expansion in liability here is caused by requiring issuers to compensate a separate class of investors who are nonetheless foreseeably injured by issuer fraud.

[17] Cf. *SEC* v. *Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Santa Fe International Corp.*, 817 F.2d 1018 (2d Cir. 1987) (court approved plan, in SEC enforcement action, for distributing funds disgorged by defendant, under which losses of person trading options were offset by profits realized by that person in stock transactions), cert. denied, 108 S. Ct. 1013 (1988).

[18] See *Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 168 (2d Cir. 1980); *Shapiro* v. *Merrill Lynch, Pierce Fenner & Smith*, 495 F.2d 228, 241-242 (2d Cir. 1974). The task of fashioning an appropriate measure of damages is best left to the lower courts in the first instance.

254, appeal dismissed, 109 S. Ct. 35 (1988); Restatement (Second) of Torts § 531 (1977) ("One who makes a fraudulent misrepresentation is subject to liability to the person or class of persons whom he * * * has reason to expect to act or to refrain from action in reliance upon the misrepresentation * * *."); *id.* §§ 533, 536; Prosser, *Misrepresentation and Third Persons,* 19 Vand. L. Rev. 231, 243-246 (1966). It would be odd to import a standing limitation into Rule 10b-5 actions—not otherwise required by the language of the statute or the Rule—that is more restrictive than the common-law rule, given that one of Congress's objectives in enacting Section 10(b) was to "rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct." *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 388-389 (1983); see also *Basic,* 108 S. Ct. at 990 n.22; *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 194-195 (1963).

Under the common law's foreseeability requirement, we think options traders would clearly have standing. The price of an option depends critically and predictably on the price of the underlying stock.[19] Because of the close connection between the stock and option markets, issuer misrepresentations that are "reasonably calculated to influence the investing public" (*SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)), will foreseeably induce reliance by traders in options on their stock. Just as stock and

[19] The value of an option depends on the price of the underlying stock, the exercise price of the option, interest rates, the time remaining to the option's expiration, and the volatility of the underlying stock price. As the price of the underlying stock increases, the value of any call option on that stock increases; as the price of the underlying stock declines, the value of the call option declines. See, *e.g.*, R. Brealey & S. Myers, *Principles of Corporate Finance* 484 (3d ed. 1988). Several formulas estimate the value of a put or call option based on the price of the underlying stock and the other factors cited above. The best known formula is the Black-Scholes options pricing model. *Id.* at 485-488 ("Every day dealers on the options exchange use this formula to make huge trades."). See also G. Gastineau, *The Options Manual* 189-210 (3d ed. 1988) for a discussion of other options pricing formulas and models. For a general discussion of option valuation, see J. Cox & M. Rubinstein, *Options Markets* (1985).

option traders both rely on issuer statements to facilitate informed investment decisions, so do they both suffer harm from false or misleading issuer representations.[20]

(3) Petitioners next suggest (Pet. 25) that it is unfair to allow option traders to recover damages from an issuer and thereby take money out of the pockets of shareholders. Shareholders, however, invariably bear the financial consequences for torts committed by corporations on third parties. And, contrary to petitioners' contention (Pet. 26-27), option traders are not, because of the supposed speculative and risky nature of option trading, less deserving of protection under the securities laws than an issuer's own security holders.[21] In any event, as the court of appeals noted (Pet. App. 12a), option trading provides many investors with a way to transfer and hedge against, as opposed to increasing, risk.[22]

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[20] Petitioners argue (Pet. 15-16) that the fraud-on-the-market theory of indirect reliance should not apply here. Review of that question, which is not presented as a separate question by petitioners, and which was not decided by the courts below, is not warranted. Petitioners' fraud-on-the-market contention has no relevance to their standing argument, since they challenge the standing even of option traders who directly rely on a defendant's misstatements.

[21] *Basic*, 108 S. Ct. at 991 ("No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells.") (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934). Cf. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 389 (1982) (expressly rejecting the suggestion that characterization of persons who invest in futures contracts as "speculators" is a basis for excluding them from the class of persons protected under the antifraud provisions of the Commodity Exchange Act).

[22] See Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, and Securities and Exchange Commission, *A Study of the Effects on the Economy of Trading in Futures and Options* II-15 to II-20 (1984) [hereinafter *Study of Trading in Futures and Options*]; Staff of Securities and Exchange Commission, *Report of the Special Study of the Options Markets*, transmitted to the House Committee on Interstate and Foreign Commerce, 96th Cong., 1st Sess. 82-90 (Comm. Print 1978); J. Cox & M. Rubinstein, *Option Markets* 444-445 (1985); cf. *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 358 (1982) (futures trading in the commodity markets allows hedging which is "facilitated by the availability of speculators willing to assume the market risk that the hedging farmer or processor wants

(4) Finally, petitioners' assertion (Pet. 23) that option traders do not benefit the issuer of the underlying security is incorrect. Although option trading does not contribute directly to the capital of the issuer of the underlying security, neither does secondary trading in the issuer's common stock. As with secondary trading in stock, however, option trading does facilitate capital formation by enhancing liquidity in the secondary markets for issuers' securities, thereby assuring that persons who buy securities from an issuer will be able to resell them readily.[23] And the existence of an options market in an issuer's securities can enhance the attractiveness of the underlying stock by providing investors with an opportunity to earn extra profits or to limit losses. Thus, option trading is recognized as highly beneficial to the functioning of capital markets, and as indirectly serving to reduce corporations' cost of capital.

On balance, we believe that affording standing to option traders furthers the statutory goals of assuring honest and efficient securities markets and of protecting investors. There is no adequate reason to deny a remedy to option traders who can otherwise establish liability under Rule 10b-5 based on affirmative issuer misstatements.

2. Several additional considerations reinforce our conclusion that the standing question decided by the Third Circuit does not call for this Court's immediate review without further development of the issue in the lower courts. First, apart from the decision below, a relatively small number of district courts have considered whether option traders have standing to sue for affirmative misrepresentations.[24] The majority of courts that

to avoid"); *United States* v. *Dial*, 757 F.2d 163 (7th Cir.) (same), cert. denied, 474 U.S. 838 (1985).

[23] See *Study of Trading in Futures and Options* at II-24; Note, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 Yale L. J. 623, 632 (1988).

[24] Three district court decisions have squarely held that purchasers of call options have standing under Rule 10b-5 to assert claims against a non-trading issuer of the underlying stock for affirmative misrepresentations. *Tolan* v. *Computervision Corp.*, 696 F. Supp. 771 (D. Mass. 1988); *In re Digital Equipment Corp. Securities Lit.*, 601 F. Supp. 311, 315 (D. Mass. 1984); *Lloyd* v.

have rendered holdings squarely on point have agreed with the court below that there is standing in these circumstances. There is no indication at this time that the courts of appeals will not reach consistent results on this issue.

Second, the lower courts have not yet addressed a number of important aspects of option trader suits, beyond the threshold question of standing, that are highly relevant to evaluating the practical impact of such litigation. For example, the measure of damages for any injuries to option traders under Rule 10b-5 was not addressed by the court below. Likewise, contrary to petitioner's suggestion (Pet. 15-16), the court did not pass on the application of the fraud-on-the-market theory to option traders. Any ultimate consideration by this Court of the standing of option traders under Rule 10b-5 would benefit from the experiences of the lower courts in working out these issues.

Third, the threshold standing issue decided in this case creates neither the need nor the opportunity for this Court to address the hypothetical questions that petitioners note about suits by holders of other types of derivative securities. For example, petitioners raise the spectre that, if standing is granted to option traders, issuer liability will be "limited only by the imagination of the financial industry in creating new security instruments based in any way on a corporation's performance" (Pet. 24).

Industrial Bio-Test Laboratories, Inc., 454 F. Supp. 807, 813 (S.D.N.Y. 1978). Only one district court decision squarely to the contrary remains unreversed. *Bianco* v. *Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

Some cases have found no standing for option traders suing on insider trading or other nondisclosure theories. See *Data Controls North, Inc.* v. *Financial Corp. of America*, 688 F. Supp. 1047, 1049 (D. Md. 1988) (denying standing to option traders in the absence of evidence of affirmative misrepresentations; distinguishing the Third Circuit's decision in this case), affirmed on other grounds, No. 88-2866 (4th Cir. May 3, 1989) (unpublished opinion); *Starkman* v. *Warner Communications, Inc.*, 671 F. Supp. 297, 305 (S.D.N.Y. 1987) (denying standing to option traders suing on the same insider trading theory that was rejected in *Laventhall*); *In re McDonnell Douglass Corp. Securities Litigation*, 567 F. Supp. 126 (E.D. Mo. 1983) (denying standing to option traders alleging failure to disclose by a non-trading issuer and insider trading based on defendant's transactions in the issuer's stock).

Petitioners specifically refer (Pet. 10-11) to options on an index based on a number of securities. But the issue of what liability might exist to traders in such "market basket" securities is not presented in this case. A grant of certiorari would not be warranted in an effort to define such abstract limitations on Rule 10b-5.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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